SCS Agency
Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Lewis | Analyst: Kristina North | Bill Number: SB 1499

Related Bills: See previous analysis | Telephone: 845-6978 | Amended Date: APTBA

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Gain From Sale of Principal Residence

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO ________________________.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 5, 1998, STILL APPLIES.

_____ OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law, this bill would allow a taxpayer, when determining the amount realized upon the sale or other disposition of property, to elect to include the amount of indebtedness discharged in connection with a short-sale of the taxpayer's principal residence.

SUMMARY OF AMENDMENT

The proposed amendments removed the bill's prior language which would have excluded from gain any income from the cancellation of secured indebtedness connected to the sale of the taxpayer's principal residence and added the language discussed in this analysis.

The proposed amendments resolve the implementation concerns raised in the analysis of the bill as introduced February 5, 1998. Except for implementation concerns and the changes noted in this analysis, the remainder of the prior analysis still applies.

SPECIFIC FINDINGS

The **current federal and state law** discussed in the department's analysis of the original bill dated February 5, 1998, still applies and is supplemented by the following.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ____X____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ____________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department/Legislative Director Date Gerald H. Goldberg 4/13/98	Agency Secretary Date	By: Date:

Under current federal and state law, "acquisition indebtedness" means any indebtedness incurred in acquiring, constructing, or substantially improving the taxpayer's principal residence that is secured by such residence. To the extent that the amount of indebtedness resulting from refinancing for the preceding purposes does not exceed the amount of refinanced indebtedness, acquisition indebtedness would include the refinancing of the indebtedness. "Home equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a taxpayer's principal residence to the extent the aggregate amount of such indebtedness does not exceed the fair market value reduced by the amount of acquisition indebtedness for such residence. The aggregate amount treated as home equity indebtedness for any period cannot exceed $100,000 ($50,000 in the case of a separate return by a married individual).

This bill would allow a taxpayer, for purposes of determining the amount realized upon the sale or other disposition of property, to include the amount of indebtedness discharged in connection with a short-sale of the taxpayer's principal residence (i.e., amounts that might otherwise be treated as income from the cancellation of indebtedness). Thus, the taxpayer could apply the $250,000 ($500,000 if married filing a joint return) exclusion of gain realized on the sale or exchange of a principal residence to exclude the income realized from a discharge of indebtedness on the short sale of the taxpayer's principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years.

This bill defines:

- "qualified residential indebtedness" as acquisition indebtedness or home equity indebtedness, as described in federal law.
- "principal residence" as qualifying for the federal exclusion of gain in the sale of a principal residence (property owned by a taxpayer that was used as a principal residence for a two-year period during the five-year period preceding the sale of the property).
- "discharged in connection with a short-sale" as a lender discharge of all or a portion of the amount of acquisition indebtedness or home equity indebtedness exceeding the sales price of the principal residence occurring at the same time as the sale or other disposition of the residence to a party other than the lender.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in revenue losses under the PITL as shown below:

Estimated Revenue Impact of SB 1499 As Proposed To Be Amended [$ In Millions]		
1998/99	1999/00	2000/01
($6)	($3)	($3)

The bill would be effective for taxable years beginning on or after January 1, 1998, with enactment assumed after June 30, 1998.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Tax Revenue Discussion

The revenue impact of this bill would be determined by (1) the number of short-sales of principal residences within a given year, (2) the amount of canceled "qualified residential indebtedness" from such sales, (3) the number of taxpayers who elect to add discharged debt to the amount realized upon a sale, and (4) the average marginal tax rate of taxpayers with short-sales. In any given year, the changing real estate market conditions and other economic conditions would influence the magnitude of potential losses.

The following is based on information provided by staff at the California Association of Realtors:

- For 1997, sales of California residential properties totaled 555,380.
- Short sales peaked in 1994 at nearly 8% of total sales. Since 1994, short sales as a percentage of total sales have declined each year. In 1997, short sales were 4.6% of total sales.
- Approximately three-quarters of total sales are sales of principal residences. (The other one-quarter of sales represented sales of second/vacation homes and rental/investment homes.)
- For 1997, the average amount of debt canceled per short sale was approximately $8,000.

For 1998, it is assumed that short sales will drop to 3.7% of total residential sales (a 20% reduction over 1997). Multiplying the projected number of short-sales of principal residences by the average debt canceled per sale in 1997 derives a projection of debt canceled for 1998 of roughly $125 million. Multiplying the $125 million by an assumed 6% marginal tax rate and by a 10% insolvency exception derives an estimated liability year loss of $7 million. (The insolvency exception is a current law exclusion from gross income for debt discharged when the taxpayer is insolvent.) Subsequent liability year losses reflect additional assumptions for (1) increasing mortgage debt outstanding and (2) potentially improving real estate market conditions.